In the Supreme Court of the United States

OCTOBER TERM, 1970

No. 1294

K. E. AND Z. M. MCAFEE, HUSBAND AND WIFE, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The findings of fact and conclusions of law of the district court (Pet. App. vii–ix) and the opinion of the court of appeals (Pet. App. i–v) are not yet reported.

JURISDICTION

The judgment of the court of appeals was entered on October 5, 1970. By order dated January 4, 1971, Mr. Justice White extended the time for filing a petition for a writ of certiorari to and including February 2, 1971. The petition was filed on February 2, 1971. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether petitioners reserved two production payments from an assignment of their interest in oil and gas leases, so that the assignment of one of the two production payments to a third party yielded depletable ordinary income rather than capital gain.

STATUTE AND REGULATIONS INVOLVED

The pertinent provisions of the Internal Revenue Code of 1954 and Treasury Regulations thereunder are set forth in the petition (pp. 3–4).

STATEMENT

Petitioner K. E. McAfee, individually, and some of the remaining petitioners,[1] as members of two partnerships, owned an undivided interest in certain oil and gas leases. They agreed to assign their interest to Island Oil Company for $700,000, with The Second Tarrant Foundation participating and paying a portion of the price. On January 18, 1961, petitioners executed an assignment to Island Oil for the following considerations: (1) $180,000 in cash; (2) a reserved production payment of $320,000, payable with interest out of 80 percent of ¾th of all oil and gas produced, saved and sold; and (3) additional payments of $200,000 payable (after Island Oil had recouped the $180,000 cash and the $320,000 production payment plus costs of exploration and development) at the rate of $1.25 per barrel for oil produced, saved and sold, and secured by a vendor's lien on Island Oil's equip-

[1] The other petitioners are parties hereto only because they filed joint income tax returns with their spouses.

ment and personal property. At the closing, petitioners assigned the reserved $320,000 production payment to Tarrant for $320,000 in cash. (Pet. App. ii, vii–viii.)

Island Oil was not obligated under the assignment to develop the leases. Nor did it guarantee sufficient production to pay off the $200,000; the assignment provided that the per barrel payments should be made "only as, if and when" oil was produced. However, engineering studies available to the parties during their negotiations indicated that there were sufficient reserves to pay the $200,000 in full, and petitioners have in fact received this sum in per barrel payments. (Pet. App. ii–iv, viii.)

The district court held that the per barrel payments were nothing more than a personal obligation of Island Oil, and that petitioners had effected a single, outright sale of their interest in the oil and gas leases to Island Oil and Tarrant for $700,000. Accordingly, since in the court's view petitioners had retained no economic interest in the leases, they were entitled to report the $320,000 received from Tarrant as capital gain. (Pet. App. vii–ix.)

On appeal, the Tenth Circuit reversed. It recognized, first, that Island Oil and Tarrant were not co-purchasers, but rather that the reservation of the $320,000 production payment created a new interest which petitioners transferred to Tarrant by separate instrument. It also held that the $200,000 in per barrel payments constituted a second retained production payment, since, under the terms of the assignment, the payments were to be made "only as, if and when"

oil was produced.[2] The court concluded that petitioners had retained an economic interest in the leases, in the form of the two production payments, that they simply sold to Tarrant the right to receive future income from oil production, and consequently that the proceeds of the sale of the carved-out production payment were taxable as ordinary income, subject to depletion. (Pet. App. i–v.)

ARGUMENT

The decision below is correct. There is no conflict or other basis for further review.

1. An assignment of mineral rights by a taxpayer who retains an economic interest in the mineral property yields depletable ordinary income, not capital gain. *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25. Such an interest was defined in *Palmer* v. *Bender*, 287 U.S. 551, in terms of the two requirements which are now set forth in Section 1.611–1(b)(1) of the Treasury Regulations, as follows:

> An economic interest is possessed in every case in which the taxpayer [1] has acquired by investment any interest in mineral in place * * * and [2] secures, by any form of legal relationship, income derived from the extraction of the mineral * * * to which he must look for a return of his capital.

"The second factor has been interpreted to mean that the taxpayer must look *solely* to the extraction of oil or gas for a return of his capital * * *." *Com-*

[2] The court observed (Pet. App. iv) that the vendor's lien retained by petitioners did not guarantee the $200,000 payout, but merely secured the per barrel payments that would become due by reason of production.

missioner v. *Southwest Expl. Co.*, 350 U.S. 308, 314.

It is settled that the reservation of a production payment by a transferor of mineral rights constitutes the retention of a depletable economic interest. *Thomas* v. *Perkins*, 301 U.S. 655; *Anderson* v. *Helvering*, 310 U.S. 404, 409–411; *Burton-Sutton Oil Co.* v. *Commissioner*, *supra*, 328 U.S. at 36. It is likewise settled that a production payment is "a specified sum of money, payable out of a specified percentage of the oil, or the proceeds received from the sale of such oil, if, as and when produced * * *." *Anderson* v. *Helvering*, *supra* at 410. Thus, in *Thomas* v. *Perkins*, *supra* at 657, the Court held that a reserved production payment which was "payable out of oil only, if, as and when produced" was a retained economic interest. And, in discussing this ruling with approval in *Anderson* v. *Helvering*, *supra* at 411, the Court noted that "[t]he decision did not turn upon the particular instrument involved, or upon the formalities of the conveyancer's art, but rested upon the practical consequences of the provision for payments of that type."

The court of appeals correctly applied the foregoing principles in the instant case. Like the interests involved in *Anderson* v. *Helvering*, *supra*, and *Thomas* v. *Perkins*, *supra*, petitioners' per barrel payments were to be made only if, as and when oil was produced. The right to receive payments thus was dependent solely on production, and constituted an economic interest under this Court's decisions and the pertinent Treasury Regulations. That receipt of the payments was reasonably assured based on engi-

neering studies does not help petitioners' case. On the contrary, this Court has twice held, most recently summarily, that whenever a production payment is carved out or created, and particularly where the payout is assured in advance, a sale of the payment yields depletable ordinary income. *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260; *Wiseman* v. *Barby*, 390 U.S. 339, reversing 380 F. 2d 121 (C.A. 10).

2. Petitioners concede (Pet. 19) that the precise issue raised here has been resolved for the future by Section 636 of the Code, as amended by the Tax Reform Act of 1969, P.L. 91–172, 83 Stat. 630. This, without more, makes the instant case an inappropriate one for the resolution of any conflict that might exist. But there is, in any event, no such conflict.

a. Petitioners assert conflict with *Helvering* v. *Elbe Oil Land Co.*, 303 U.S. 372, contending that under that decision they effected a sale of their entire leasehold interest because there was no obligation on the part of Island Oil to develop the leases, and because they intended to effect a sale (Pet. 9–15). This contention is without merit.

In *Elbe Oil*, there was an assignment of an oil and gas lease for $2,000,000 (of which $350,000 was to be paid at the outset and the balance in four annual installments) plus one-third of the net profits after the transferee was reimbursed for its expenditures in the acquisition, development and operation of the properties. The Court held that the transaction was a sale notwithstanding the retention of a net profits interest. The Court did not appear to attach any particular significance to the absence of an obligation

on the part of the transferee to develop the properties; it referred only to the fact (303 U.S. at 375) that the transferor "did not retain any interest or investment" in the properties.

Thereafter, in *Burton-Sutton Oil Co.* v. *Commissioner, supra,* the Court held that a reserved net profits interest constituted a retained economic interest, so that an assignment of mineral rights was not a capital transaction. In so holding, the Court noted in passing that the agreement before it required the transferee to develop the property, whereas the agreement in *Elbe Oil* contained no such requirement. But the Court stated the primary ground for distinguishing *Elbe Oil* as follows (328 U.S. at 36):

> The issue upon which this Court passed [in *Elbe Oil*] was the classification of the deferred payments. * * * These deferred payments were not payable out of oil sales but were payable absolutely, unless there was an abandonment. This Court concluded that the addition of a provision for the payment of a share of net profits did not qualify "in any way the effect of the transaction as an absolute sale." * * * In view of what we have said in this and in the *Kirby Petroleum* case as to the economic interest in the oil of a recipient of a share of the net profits, *the holding of Elbe should not be extended to the facts of this agreement.* [Emphasis supplied.]

Obviously, in *Burton-Sutton* the Court was concerned with limiting the import of *Elbe Oil.* To this end, it distinguished *Elbe Oil,* principally as a case involving large deferred payments in fixed amounts.

Burton-Sutton did not establish any general principle that a transfer of a mineral interest, with an economic interest retained, is a capital transaction if the transferee is not required to develop the property, or if the instrument of assignment is couched as a sale. To the contrary, it recognized without qualification that (328 U.S. at 36)—

> we have construed an assignment of oil leases for cash and a deferred payment, "payable out of oil only, if, as and when produced," as the reservation of an economic interest in the oil—not a sale. *Thomas* v. *Perkins,* 301 U.S. 655.

The form of the instrument is immaterial. *Burton-Sutton Oil Co.* v. *Commissioner, supra,* at 32. As the Court explained in *Palmer* v. *Bender, supra,* 287 U.S. at 555–556, "[t]he formal attributes of those instruments or the descriptive terminology which may be applied to them in the local law are both irrelevant."[3]

Furthermore, *Elbe Oil* did not involve, as does the case at bar, the carve-out and sale of a production payment on which the payout is assured. That aspect of the instant case brings into play *P. G. Lake* and *Wiseman* v. *Barby, supra,* and those decisions require

[3] Recent appellate decisions dealing with the question whether a transfer of mineral rights is a capital transaction have not turned on the "intent" of the parties or the presence or absence of an obligation to develop on the part of the transferee, but solely upon whether or not an economic interest was retained. See, *e.g.*, *Oliver* v. *United States*, 408 F. 2d 769 (C.A. 4); *Hair* v. *Commissioner*, 396 F. 2d 6 (C.A. 9); *Wood* v. *United States*, 377 F. 2d 300 (C.A. 5), certiorari denied, 389 U.S. 977; *Rabiner* v. *Bacon*, 373 F. 2d 537 (C.A. 8); *United States* v. *White*, 401 F. 2d 610 (C.A. 10); *Commissioner* v. *Pickard*, 401 F. 2d 615 (C.A. 10); *Schreiber* v. *United States*, 382 F. 2d 553 (C.A. 7).

that the proceeds of the sale to Tarrant be treated as depletable ordinary income, not capital gain.

b. Likewise without merit is petitioner's claim (Pet. 16–19) that the decision below conflicts with the law of the Eighth Circuit as reflected in *Commissioner* v. *Remer,* 260 F. 2d 337. *Remer* was unusual in that it involved iron ore already extracted from the ground and stockpiled, rather than minerals in place. Moreover, it has been limited to its particular facts by the Eighth Circuit's subsequent decision in *Rabiner* v. *Bacon,* 373 F. 2d 537. In that case, the court held, following *Palmer* v. *Bender, supra,* and cognate decisions, that the proceeds of a transfer of mineral rights was depletable ordinary income because—without regard to the "intent" of the parties or an obligation on the part of the transferee to develop the property—the transferor remained dependent upon production and thus retained an economic interest. Contrary to petitioners' assertion (Pet. 20), therefore, the instant case would be decided the same way by the Eighth Circuit as it was by the court below.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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